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# First Quarter 2014

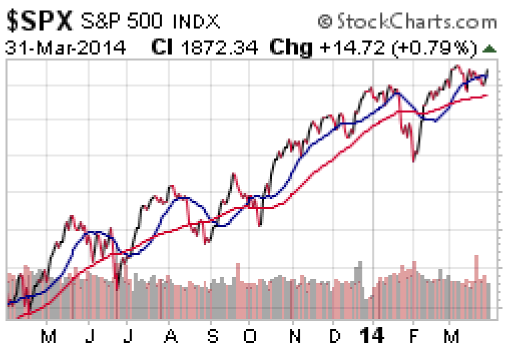


**Fig. 1 – S&P 500**

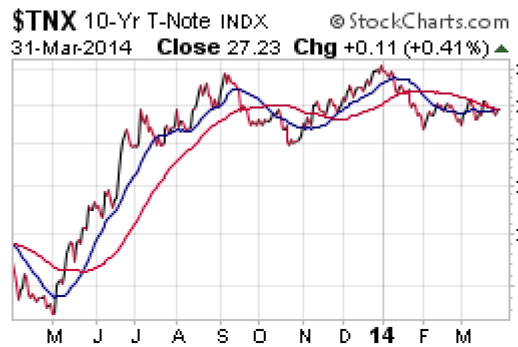


**Fig. 2 – 10 Year U.S. Treasury Yield**

Most U.S. stock indices inched higher in the first quarter of 2014. The large cap S&P 500 rose 1.8%, (**Figure 1**), while the Dow Jones 30 Industrials lost 0.2%. International markets logged mixed results. The MSCI Europe, Australia and Far East Index gained 0.7% as European economies appeared to be climbing out of their latest slowdown. Weakness in emerging country stocks continued, with the MSCI Emerging Markets Index falling 0.8%.

According to the research service Factset, 71% of S&P 500 companies topped earnings expectations for the fourth quarter of 2013, while 62% beat revenue estimates. Earnings grew for the fifth straight quarter, rising 8.5% when analysts had only been expecting a gain of 6.3%. For the first quarter of 2014, analysts now expect large company earnings to be flat, a large drop from the 4.4% growth forecast at the beginning of the quarter. Weather has been a significant factor in reduced company guidance, and the market's steady performance this quarter is indicative of the acceleration in earnings growth expected in the second half of the year.

2014 began with forecasts for the same steady economic improvement that lifted equities in 2013. However, weather played a large part in crimping activity, as the harshest winter in memory hit the Midwest and, to a lesser extent, the Northeast. The impact was felt in many industries, including housing and apparel, and was probably only a positive for heat-providing utilities, which scored the largest gains among S&P 500 sectors in the quarter. While some construction was undoubtedly delayed, existing home sales were close to expectations, and permits for new construction rose during the quarter.

Other economic indicators generally showed strength in the quarter. The employment situation continued to slowly improve. Initial weekly jobless claims remained low, and, after dipping in January, job growth exceeded expectations in February. Purchasing manager surveys also slipped mid-quarter, with manufacturing briefly signaling a slowdown, but picked up again in March, led by new order growth.

The quarter also marked the beginning of Janet Yellen's tenure as Chair of the Board of Governors of the Federal Reserve. Market watchers have widely expected Ms. Yellen to continue the current policy of accommodation, promoting economic growth. In her first interview following the release of the Fed's statement in March, she suggested that the Fed might start to increase interest rates about six months after tapering off the monthly bond

***Index returns taken from Morningstar.com and iShares.com***

purchases that have helped to keep longer rates low. Both stock and bond markets initially swooned after this comment, on fears that higher rates will hurt the economy. But Ms. Yellen finished the first quarter with a speech that boosted optimism (and stocks), promising that the Fed will remain accommodative as long as needed.

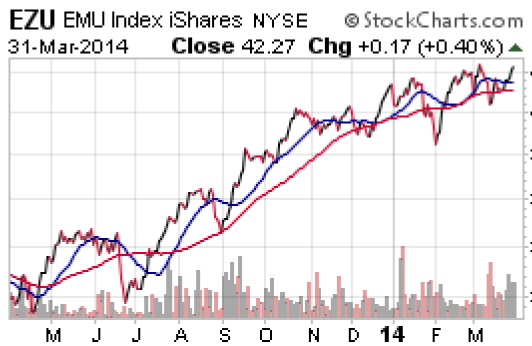

Fig. 3 – iShares MSCI EMU Index

Fig. 4 – iShares FTSE China 25 Large Cap

Stocks outside the U.S. continued to post divergent results, with the developed world generally outperforming emerging economies. The countries of the European Monetary Union (EMU – Figure 3) appear to be recovering from the sovereign debt crisis of 2011. Italy, for instance, has seen improving business confidence for five consecutive months, and survey readings have reached levels not seen since 2011. Similarly, French manufacturing surveys suggest solid and strengthening growth. Stocks in these countries were able gain ground in the first quarter, while digesting the turmoil engendered by Russia's annexation of the Crimea from neighboring Ukraine. This may bode well for future, less tumultuous quarters.

Most emerging markets, as noted earlier, fell in the quarter. Stocks in China were among those to drop (Figure 4), as the expected growth rate in China also continues to fall. It was also reported that China would suffer its first corporate bond default, with more expected. Over the long term, this is a needed development, and a sign that leaders in China will allow its markets to function more independently, with less government intervention. In the near term, however, a rising corporate bond default rate may be difficult for equities to overcome.

As of this writing, slowing in China seems unlikely to halt growth in the U.S. economy. Employment continues to trend higher, and consumer spending is likely to rebound as spring finally takes hold. Stocks should continue to do well in this environment. Bonds, while still likely to produce positive returns, may be pressured later this year as economic strength pushes yields higher. Weakness overseas will remain a source of concern, and an area that we will watch closely, as we search for future investment opportunities.

We hope that, after this unusually harsh winter, you are enjoying warmer weather.

Sincerely,

Kenneth M. Bernard, CFA